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UNCLAS SECTION 01 OF 02 BANGKOK 007000

SIPDIS

STATE FOR EAP/MLS AND EB
TREASURY FOR OASIA
COMMERCE FOR 4430/EAP/MAC/KSA
STATE PASS TO USTR FOR WEISEL, COEN

E.O. 12958: N/A
TAGS: ECON EFIN ETRD TH
SUBJECT: EXPORTS REVIVE THAI ECONOMY

REF: A. BANGKOK 6217
¶B. 04 BANGKOK 7349
¶C. BANGKOK 3463

¶1. Summary: After a weak showing in the first quarter, the Thai economy has strongly recovered, achieving 4.4 percent GDP growth in the second quarter with even stronger growth anticipated for the second half. Exports account for almost all this growth as domestic consumption and private investment remain weak. Inflation, which grew at 6 percent in September, is a concern but should be managed as the Bank of Thailand raises interest rates and energy prices stabilize. Thailand's reliance on exports is reflected in RTG efforts to rapidly negotiate as many Free Trade Agreements as possible. As Thailand's most important export market, we believe that we will ultimately be successful in our bilateral FTA talks with the Thais, even though they will have to swallow hard to accept some of our market-opening demands. End Summary.

Growth is Back

¶2. Thailand's GDP rebounded from its poor first quarter performance, growing 4.4 percent over the previous year's second quarter. While third quarter GDP will not be released until December, the outlook is positive. Growth will likely be led by a 22.7 percent increase in exports for the quarter compared to 13 percent export growth in the first half. Exports benefited from various factors: a continuing upturn in the business cycle of the global electronics sector, an increase in vehicle exports as new production facilities came on line, a recovery of the tourist sector post-tsunami, and an end to the drought which negatively affected food exports in 2004. In addition, prices received for many of these goods (especially rubber) were higher than last year as inflationary costs were to some extent passed through to buyers.

¶3. An additional impetus to GDP will be provided by a slower rate of import growth compared to the first half of 2005. The key factor in this slowdown was a reduction in the volume of oil imports in the quarter following the end of government subsidies on diesel in early July. The anticipation of the end of subsidies caused significant stockpiling of oil in the first half leading to imports of crude 30 percent above normal volumes. In the third quarter, oil imports reverted to normal levels. Due to government suasion, gold imports also fell and state-owned enterprises appeared to delay imports of capital goods. Finally, consumer demand was weak, limiting growth of consumer imports. All this combined to reverse the trade and current account deficits of the first half and turn them into surpluses of US$200 million and US$1.2 billion respectively in the latest quarter.

But Only Thanks to Exports

¶4. This export-led growth is not reflected in other sectors. Consumers, hit by rising energy prices, inflation, rising interest rates and with already-high debt burdens, limited their new purchases so that domestic consumption for the quarter was basically flat. Similarly, private investment grew by only 5.6 percent for the quarter. Sales from inventory represented an abnormally high percentage of total sales for the quarter. This was reflected in weak levels of investment and manufacturing production growth as some of the inventory overhang was worked off. Increased government expenditure (funded by strong government revenue growth in the wake of better tax collection capabilities, greater consumer use of formal, VAT-paying markets in lieu of informal markets, and the running down of tax-loss carryforwards from the crisis era) helped alleviate some of this private sector weakness.

Inflation a Concern

¶5. The greatest current concern of the Bank of Thailand and most analysts is inflation which reached 6 percent in September (core inflation, excluding food and energy, was 2.3

percent). Most of the inflation has been caused by the end of diesel subsides which has increased costs throughout the economy over the last three months (ref A). Most analysts expect that, assuming crude prices stabilize or decline from current levels, inflationary pressure should peak by this year's fourth quarter and then return to a 2-3 percent annual range. Aside from oil prices, an additional risk to this scenario is the extremely tight labor market with unemployment falling to 1.4 percent in August. While the Thai data includes numerous persons the US would consider severely underemployed, anecdotal evidence indicates that available skilled workers are becoming harder to find. As the auto and electronics industries continue to expand production, the Bank of Thailand is concerned that a wage-price spiral could result.

¶6. In an effort to keep inflation at bay and to close the spread between US and Thai short-term rates, the BoT has aggressively raised its policy rate (by 125 basis points) over the course of 2005. This has had the desired effect of helping reduce domestic consumption and the corollary effects of keeping the baht strong (it has appreciated 4 percent against the dollar since July) and bank margins under pressure. Real interest rates on consumer bank deposits remain negative, however, and the BoT is expected to raise rates an additional 50-100 basis points (to 3.75-4.25 percent) before it eases off. This will continue to restrain the ability of Thai consumers to consume as they work to pay off their outstanding debts at higher interest rates.

¶7. Despite these headwinds, most analysts remain positive. The BoT has raised its GDP forecast for 2005 from 3.5-4.5 percent to 4.25-4.75 percent and some analysts have followed suit. They see continued strong export growth, especially as Japan continues its economic resurgence and Thailand makes further inroads into the China market. Also, in 2006 the RTG's much-anticipated "megaprojects" (US$48 billion in infrastructure development over 5 years, see ref B) is expected to get fully underway. Finally, tourism is expected to fully recover from the 2004 tsunami by next year; already Phuket hotels anticipate 80-90 percent occupancy for their high season this winter. An avian influenza outbreak would, obviously, change these forecasts.

¶8. Comment: The Thai economy continues to be largely well-managed with problem areas such as inflation being addressed. However, Thailand remains exceptionally reliant on exports for its economic well-being, comprising about 55 percent of GDP so far this year. The RTG and many analysts presume that, so long as China continues its rapid growth, Thailand will be pulled along in its wake. We occasionally need to remind RTG officials that the US is Thailand's second largest export market and source of its largest trade surplus, and that one reason the PM sought an FTA with the US is to cement Thailand's position in their most profitable market. We believe that after more than fifteen months of negotiations, the RTG now accepts that we will not compromise on the principle of an agreement that is comprehensive and lays out a plan that fully opens Thai markets to US service suppliers and investors.
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